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February 14, 1994

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

BY HAND

Chairman Reed Hundt
Commissioner Andrew Barrett
Commissioner James H. Quello
Federal Communications Commission
1919 M Street, N.W.
Washington, D. C. 20554

Dear Chairman Hundt, Commissioner Quello and Commissioner Barrett:

Ovation: The Fine Arts Network deeply appreciates the opportunity to meet with you and your staff concerning the pending further rulemaking regarding cable television rates and its potential impact on new program services. The actions that the Commission takes in that proceeding will directly affect the future ability of companies such as Ovation to bring valuable new services to the American public.

Ovation is a new cable television network dedicated to the fine arts -- drama, dance, jazz, opera, classical music, literature, profiles, museums and other visual arts. We are in an advanced stage of development and plan to begin satellite delivery near the end of this year. Our research and that of others have confirmed a renewed interest in the arts, and the parallel revulsion at violence in our streets and on our screens is well known. The National Cultural Alliance, comprised of leaders from the advertising, arts and television community, has found that Americans want more arts programming on television, and Ovation has received unparalleled interest in the general and industry media. No other broadcast or cable network presently offers more than a relatively small fraction of arts programming. With the goal of extending the reach of the arts as broadly as possible, Ovation will offer the network free to operators as an advertiser-supported basic service where possible. J. Carter Brown, long-time Director of the National Gallery of Art is Chairman of Ovation, and Dr. Harold E. Morse, founder of The Learning Channel is CEO of the Company. Other founding directors include Terry Sanford, former North Carolina Senator and Governor and Duke University President, and Anthony S. Harrington, a founder of Telecom*USA.

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Cable re-regulation is having serious -- and we are certain unintended -- consequences for Ovation and other new program services. The rules, both as adopted and as proposed, are discouraging cable systems from adding new services and expanding channel capacity. Neither result is consistent with the nation's shared goal of a robust information infrastructure, with maximum diversity and resulting economic growth. For example, the Commission's proposed rules governing rate adjustments for new channel additions do not take into consideration the significant costs and market risks that such additions entail -- particularly additions of advertiser-supported start-up services that must develop audience awareness and critical mass. Similarly, many cable operators must upgrade their systems to increase channel capacity to accommodate new services. Yet the current rules create substantive and procedural deterrents to such upgrades.

We were heartened by your common interest in correcting these problems. We are likewise pleased to find that such concerns are shared by knowledgeable members of the Administration and the Congress.

We strongly believe that rules can be crafted that provide opportunities for new program services without undercutting consumer rate protection objectives. We particularly appreciate your invitation to submit our analysis and suggestions regarding possible means of accomplishing these ends. We have attached our proposal with this letter. The proposal eliminates current disincentives for cable operators to add new program services and expand channel capacity through system upgrades.

The corrections we propose are necessary no matter what other changes the Commission makes to its cable rate rules. However, they take on particular importance if further rate reductions are mandated for existing system configurations. As we discussed, we urge that any further rate reductions be at a modest level and/or be targeted only toward any in the industry whose actions are inconsistent with the letter and spirit of the regulatory framework. But as the Commission previously recognized, any revisions in the benchmark require reconsideration of the methodologies for adding channels, and the impact on new services generally.

We would be pleased to discuss further with you or your staff any aspects of our proposal or possible alternatives or variations that might be considered. You may direct any calls to Tony Harrington at 202/637-5646 or to Peter Rohrbach at 202/637-8631.

Yours truly,

Anthony S. Harrington

Anthony S. Harrington

ASH/clh
cc: Mr. William F. Caton
Acting Secretary
Federal Communications Commission

February 14, 1994
MM Docket No. 92-226

OVATION PROPOSAL

The Commission has recognized that rate regulation could reduce incentives for channel expansion and investment in new capacity, and has actively sought solutions to this problem. Last August, for example, the Commission tentatively concluded that "any methodology we adopt [for channel additions] should achieve the goals of protecting consumers from unreasonable rates while assuring the continued growth of the cable industry and the additional services that it can provide to subscribers." First Order on Reconsideration, Second Report and Order, and Third Notice of Proposed Rulemaking, MM Docket No. 92-266, at ¶ 136 (released August 27, 1993) ("Third Notice"). Ovation agrees with this conclusion and believes that adjustments in the Commission's treatment of channel additions and system upgrades are necessary to meet these important goals.

Section I of this Proposal provides alternative approaches for eliminating disincentives to add new services that are present in the current benchmark rules. It is critical that the Commission consider the fact that future investment decisions are being made in a different environment today than may have existed last summer. Modifications are particularly important because press accounts suggest that the Commission may be considering adjustments to the benchmark calculation that would result in further overall rate reductions. Unless countervailing changes are made, Ovation is concerned that the benchmark adjustments may eliminate opportunities for new programming services, particularly those that are entirely or predominantly advertiser-supported. Indeed, the Commission has signaled its willingness to make such changes:

> Any revised benchmark that we could adopt could affect the methodology that we select for use of the benchmark to adjust rates when channels are added or deleted from regulated tiers. We thus are providing notice that any benchmark methodology that we select will reflect any modifications to the benchmark that we might adopt in the Second Reconsideration. Id. at ¶ 136 n.245.

Ovation proposes benchmark modifications below that protect opportunities for consumers to enjoy expanded program options from new services.

Section II discusses additional steps that are required to encourage cable operators to expand capacity, thereby addressing serious capacity limitations that also are thwarting new cable services. Ovation suggests that such upgrades be treated as "external costs" subject to limited safeguards. We recognize that the Commission has previously considered the possibility of treating voluntary upgrades under the price cap mechanism and concluded that such costs should be recovered through cost of service showings, rather than as external costs. Id. at ¶¶ 94, 97. However, the Commission also underscored the importance of establishing criteria for treatment of external costs that serve vital policy objectives "such as assuring the continued growth of programming diversity." Id. at ¶ 90. And the decision stressed that if treatment of system upgrades under cost of service rules "thwarts the development of new technologies and services, [we] would review our decision as necessary." Id. at ¶ 94. See also id. at ¶ 114 ("we attach great importance at this stage of rate regulation to the continued growth of programming"). These issues are discussed further below.

I. Cable Rate Rules Should Encourage, Not Deter, the Addition of New Services -- Particularly Start-up Services that Carry the Greatest Economic Risks

Consumers will be denied the benefit of new cable program services if the Commission's benchmark rate regulations do not recognize that the addition of new services entails higher risks and costs than the ongoing provision of preexisting, well-established cable channels. This problem is particularly serious for start-up services such as Ovation that have not yet reached a threshold critical mass of subscribers. Disincentives to add new program services would be even greater if the Commission reduces the benchmark rates for current cable channels. In that event the difference between the cost of adding innovative new services and the cap on permitted prices could increase even further.

To correct this serious problem, the rate rules should differentiate between new and old channels. One solution would be to forbear completely from regulating rates charged for new channels. However, on the assumption that the Commission is not currently prepared to take that step, several alternative approaches to the regulation of new services are presented below. In deciding among these options, the Commission should err on the side of actions that are more likely to increase program diversity by encouraging expanded channel carriage.

Ovation would emphasize that the rules it proposes here are content neutral and not designed to favor any particular program service. Ovation will succeed or fail based on its acceptance in the market. All we are asking is that cable rate rules not have the unintended consequence of creating an artificial

barrier to market entry, and thereby deny consumers access to the services they might otherwise desire.

Alternative A: "New Services" Defined as New to a Cable System

1. When new program services are added to a cable system operating under benchmark regulation, the adjusted cap should consist of the sum of two subcaps: (a) an "old services" subcap, i.e. the permitted charge for the existing channels on the system as of September 1, 1993, and (b) a "new services" subcap, i.e. (i) the benchmark rate for the total number of channels on the system multiplied by the number of new services added after September 1, 1993, plus (ii) the actual cost (plus 15%) of the new programming charged to the cable system by the program service vendor.

2. When services are deleted from a cable system, the cap should be adjusted downward based on whether the affected service is "old" or "new." Deletion of an "old" service would result in a proportionate reduction in the "old services" subcap under the benchmark rules; deletion of a "new" service would result in a corresponding reduction of the "new services" subcap reflecting the per channel benchmark and the program cost of the deleted service.

Discussion

This approach expands on the first methodology for program service additions discussed at ¶137 of the Third Notice. The Commission tentatively proposed not to adopt this methodology because it feared it would permit pricing above observed economies of scale reflected in the benchmark study, and because it would result in different benchmark rates for "old" and "new" services.

However, it is not at all clear that the economies of scale, if any, of adding a new channel outweigh the costs and risks of doing so. Ovation and other new services are having difficulty finding channel capacity on many systems even though we at least initially intend to offer our service at no cost to the cable operator. From this it is possible to conclude that the costs of adding a new service often exceed any incremental economies of scale for a given system. Otherwise a system would add a free service.

Similarly, the Commission should not be concerned about drawing distinctions between "old" and "new" channels. New channels carry a substantially greater risk to both program service vendors -- who must have channel access -- and the cable operators who are asked to make that access available. This is particularly true for start-up services that increasingly will look for viewers in narrow niche markets, drawing on the accumulated viewers from many systems across the country. It is appropriate that this additional risk be reflected in the benchmark system. At the least, the Commission should give the benefit of the doubt to diversity and new services in its benchmark formulas.

Ovation's proposal has two features for new services. First, it would not directly penalize a cable system for adding a new service by reducing the cap for old service rates. As discussed above, the "economies of scale" rationale for such a penalty is outweighed by other risks that new services entail. As a result, the benchmark for preexisting services should not be affected by a service addition.

Second, Ovation's proposal would not indirectly penalize a system for program additions through a "programming offset". Instead, the proposal would allow a cable operator to recover a per channel benchmark as well as its actual programming costs for the new service (plus 15% to cover administrative costs). As a practical matter, most new program services added to a cable system are, like Ovation, likely to be provided to the operator at little or no cost. As a result, this element of the formula is unlikely to affect rates in most cases.

We recognize that the <u>Third Notice</u> suggests that programming costs already are included in the benchmark, and therefore that a proposed "programming offset" should be subtracted from adjusted benchmark rates in the case of service additions. However, in practice such an adjustment creates an additional incentive not to add a new service. For example, a system that added Ovation would be required to deduct an "average" programming "offset" from its per channel benchmark. Depending on its overall programming costs, that offset could be significant. Yet no compensating mechanism is present to permit the cable operator to recover for the extra costs and risks of adding a new service. Ovation believes that those burdens are likely to exceed any average programming cost built into the benchmark. But for administrative simplicity, we suggest that the Commission not include an offset for new services, and instead permit recovery of a percentage override on programming costs. This balance creates a more reasonable starting point for new service addition rules.

We are not confident that even the methodology outlined above goes far enough to encourage cable systems to add new services; it still may not cover a system's start-up and ongoing operating costs for such a service. Our proposal attempts to recognize the Commission's desire to be conservative in this area. We respectfully urge the Commission to resolve any remaining uncertainties it may have in favor of adopting our proposal. The methodology set forth here at least removes the most obvious disincentives for new service additions. If the Commission believes that it may create a minor incentive for additions (a conclusion that is not certain) we urge that such a result be viewed as a positive one.

Alternative B: "New Services" Defined as New to the Market

This alternative would involve the same methodology as Alternative A, with separate subcaps for "new" and "old" services. However, in this case " new services" would be defined as services that were not carried on cable systems serving at least 10% of the country (or some similar threshold) as of a fixed date. 1/ *"Old services" would be those that had met the threshold by that date.*

Under this alternative, when a cable operator adds an unestablished cable program service, it would be eligible to treat that service as "new" under the rules set forth above. However, when an operator adds a more established channel, it would only be eligible to receive a proportionate increase in the benchmark as proposed in the third methodology set forth in ¶139 of the Third Notice.

Discussion

Alternative B is more restrictive than Alternative A because it would not allow a cable system to qualify for the somewhat more favorable "new services" treatment when it adds a program service that already was well-established at the time rate regulation began. Arguably, for example, an operator incurs less economic risk when it adds a channel that already has reached a relatively wide potential audience than when it adds a new start-up. Ovation believes that this approach still would unduly deter program diversity. In many cases a cable operator may find it most efficient to add channels in groups (for example, following a system upgrade). The operator could be deterred from making the expansion at all if some of the services it wished to add were classified as "old" and therefore subject to unfavorable rate treatment. In sum, Ovation strongly prefers Alternative A; Alternative B is less satisfactory.

Alternative C: "New Services" Later Convert to "Old Services"

If "new services" are defined as any channel additions by a system (as in Alternative A), then such services could convert to inclusion under the "old services" cap five years after the particular addition occurs. If "new services" are defined as start-up

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1/ An even more restrictive alternative would be to define "new services" as those commencing initial program distribution after a fixed date. Ovation is indifferent because its launch date is scheduled for later this year. However, a coverage-based standard is fairer to newer services that are still developing in the market.

channels (as in Alternative B), then they could convert to "old services" treatment five years after the 10% national availability standard is met. 2/

Discussion

Some may ask whether new services should be reclassified as "old" after some period of time, however they are initially defined. Ovation believes that incentives to add new channels could be seriously undermined if those incentives are automatically eliminated in the future. We believe the best course would be for the Commission to reserve the question for now, and revisit it later as part of any overall review of cable rate regulation. If at that time the modest incentives to add and maintain new services are found to have had a disproportionate impact on rates, the Commission may then choose to establish a mechanism to migrate those channels to come under the "old services" cap.

Alternatively, the Commission could establish such a mechanism now. For example, it could require rates for a "new service" channel to be recalculated under the "old service" rules five years after it is added to a given cable system (under Alternative A) or five years after it reaches critical mass (under Alternative B). Again, Ovation believes that such a sunset of "new services" treatment is unnecessary, particularly at this time. However, we would not oppose such a rule if the Commission decides it is otherwise necessary in order to adopt the new services methodologies discussed above.

Alternative D: Limits on "New Services" Treatment

As a final safeguard, operators could be expressly prohibited from deleting and then later adding particular program services to shift them from "old" to "new" treatment. In addition, the "new services" subcap could be subject to an upper restriction to limit the percentage of channels, or the percentage of system revenue, falling into this category.

Discussion

The methodologies discussed above are conservative and should protect consumers against excessive rates. However, in the event that the

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2/ Alternatively, the start-up service could convert to "old services " treatment on a system-by-system basis five years after a given system adds the service. Either way the five year limit proposed here could be adjusted to be longer, but it should not be shortened given the need to create meaningful incentives for programming expansion.

Commission remains in any way concerned, it can adopt express limitations on the "new services" category, including limitations on the use that an operator can make of the category. Put simply, even a limited correction of the current disincentive to add new services would be better than no correction at all. However, Ovation would ask that any limitation on the upper bounds of the "new services" category be no greater than necessary to serve as an ultimate safeguard against the possibility of cable operator abuses. And we ask that a mechanism be included to sunset the restrictions within a few years if no abuses develop.

II. Cable Rate Rules Should Encourage System Upgrades Necessary to Expand Program Diversity

A second major problem for new program services is inadequate cable system capacity. Even if rate disincentives to add new services are corrected, operators still will be unable to expand program diversity if their systems are filled to capacity. Thus, Ovation and other new services have a critical interest that the Commission's rules not discourage system upgrades and expansion.

Proposal For Voluntary and Involuntary Upgrades

The Commission should presume that voluntary cable system upgrade investment is reasonable and permit such upgrades to be treated as "external costs" under the price cap mechanism provided that: (1) local franchising authorities receive advance notice of new capital investment budgets, and (2) new capital investment alone may not justify more than a 10% increase in a price cap in any one year. When system upgrades are required by local franchising authorities, the 10% restriction should not apply.

Discussion

As a general rule, system upgrade costs only should raise regulatory concerns if the regulated entity has incentives to "gold-plate" its system. Such incentives are present in the case of a rate of return monopoly utility, where increases in investment result in increases in return. However, cable companies have not operated under rate of return regulation, and therefore have had no such incentives. If anything, they have had incentives to minimize capital investment insofar as their prices and returns have not related directly to the amount of such investment.

As a result, cable companies tend not to have excess channel capacity for new services; quite the contrary, the real problem is capacity shortages that serve as entry barriers for new programmers. The price cap rules should be very sensitive to this issue, which is constraining the ability of new services like Ovation to reach their audiences.

Ovation recognizes that -- at least in theory -- cable operator incentives not to "gold plate" might change under cost-of-service regulation (or even under price cap regulation where upgrades are judged under a cost-of-service standard). In practice, however, developing competition from direct broadcast satellites, telephone companies and others make it far more likely that a cable company will continue to engage in only prudent and reasonable system upgrades. As competition develops, cable companies cannot be assured that they will be able to earn a reasonable return on capital investment -- even if permitted to do so by the cost-of-service rules. Significantly, such developing competition will constrain cable company capital investment decisions now, well before arrival of active service competition itself.

Given the importance to the nation of encouraging local infrastructure development, the Commission should take care not to deter reasonable cable investment through its rate regulation rules. Ovation believes that the Commission should reconsider its decision not to permit system upgrade investment as an external cost (including a reasonable return). To the extent the Commission feels it necessary to test the reasonableness of upgrade investment -- applying a regulatory check on top of the preexisting market check -- its test should be as simple and nonburdensome as possible. The proposal set forth above is the maximum regulation of upgrades that should occur.